[COMMITTEE PRINT]

TAX REDUCTION AND REFORM PROPOSALS

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ITEMIZED DEDUCTIONS

PREPARED FOR THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

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I. INTRODUCTION

This pamphlet is the first in a series prepared by the staff of the Joint Committee on Taxation for use by the Committee on Ways and Means in its consideration of the Administration's tax reduction and reform proposals. A previous staff pamphlet (dated January 27, 1978) provided a brief summary of those proposals.

This pamphlet discusses in detail the Administration proposals regarding itemized deductions, as follows: (1) State-local nonbusiness gasoline taxes; (2) State-local nonbusiness sales taxes; (3) State-local nonbusiness personal property taxes; (4) State unemployment disability fund taxes; (5) accounting rules applicable to certain taxes; (6) medical expenses and casualty losses; and (7) political contributions.

For each of these deduction proposals made by the Administration, the discussion in this pamphlet includes an explanation of present law, background information on the item (including legislative history), a description of the Administration proposal, a description of alternative proposals submitted by Members which relate specifically to the particular Administration proposal being discussed, a statement of issues involved with respect to consideration of the Administration proposal, and the estimated revenue effect of the Administration proposal.

A brief summary of the Administration proposals and of the related present law precedes the detailed discussion.

All the Administration proposals described in this pamphlet are proposed to be effective for taxable years beginning after December 31, 1978.

II. SUMMARY OF ADMINISTRATION PROPOSALS

A. State-Local Nonbusiness Gasoline Taxes

Present Law

An individual who itemizes deductions can deduct State and local taxes imposed on gasoline, diesel, and other motor fuels not used in business or investment activities (for example, taxes on gasoline consumed in personal use of a family car). With respect to State gasoline taxes, an itemizer may compute the deductible amount from tables furnished by the Internal Revenue Service or from receipts showing the exact amounts of taxes paid.

Administration Proposal

The deduction for State and local taxes on motor fuels not used by the taxpayer in business or investment activities would be repealed.

B. State-Local Nonbusiness Sales Taxes

Present Law

An individual who itemizes deductions can deduct State and local general sales taxes not related to business or investment activities (for example, sales taxes on items of personal clothing). An itemizer may compute the deductible amount from tables furnished by the Service or from receipts showing the exact amounts of taxes paid.

Administration Proposal

The deduction for State and local general sales taxes not related to business or investment activities would be repealed.

C. State-Local Nonbusiness Personal Property Taxes

Present Law

An individual who itemizes deductions can deduct certain State and local taxes imposed on the value of personal property which is neither used in a trade or business nor held for production of income (for example, annual ad valorem property taxes imposed on automobiles and boats used for personal purposes).

Administration Proposal

The deduction for State and local taxes on personal property not business-related or investment-related would be repealed.

D. State Unemployment Disability Fund Taxes

Present Law

The U.S. Tax Court has ruled, in two cases, that amounts withheld from an employee's wages as mandatory contributions to a State unemployment disability fund are deductible, if the employee itemizes,

as State income taxes (or, in the alternative, as employee trade or business expenses).

Administration Proposal

Deductions for employee contributions to a State unemployment disability fund or to private employer plans established in lieu thereof would be disallowed.

E. Taxes Paid in Connection With Capital Assets

Present Law

A taxpayer can deduct, in the year paid or incurred, certain State, local, or foreign taxes, even if such taxes are incurred on acquisition of a capital asset. However, real property taxes classified as "construction period" taxes must be capitalized and amortized over specified periods.

Administration Proposal

As summarized above, deductions for State-local nonbusiness general sales, motor fuel, and personal property taxes would be repealed. State, local, and foreign income taxes and real property taxes would continue to be deductible in the year paid or incurred (except that construction period real property taxes would continue to be capitalized as under present law). Business-related or investment-related taxes would have to be capitalized, rather than being fully deductible in the year paid or incurred, if incurred on acquisition of a capital asset.

F. Medical Expenses and Casualty Losses

Present Law

An individual who itemizes deductions can deduct (1) one-half of the cost of his or her medical insurance premiums (up to $150) and (2) other unreimbursed medical expenses in excess of 3 percent of the taxpayer's adjusted gross income (including drug costs exceeding one percent of adjusted gross income and the remainder of medical insurance premiums). A separate itemized deduction is allowed for personal casualty and theft losses in excess of $100 per occurrence.

Administration Proposal

Casualty and theft losses (in excess of $100 per occurrence) would be aggregated with qualifying medical care expenses, and the aggregate amount would be allowed to itemizers as a single "hardship deduction" to the extent exceeding 10 percent of adjusted gross income. Both the separate partial deduction for insurance premiums and the one-percent floor on drug costs would be eliminated, and the definition of qualifying medical expenses would be narrowed with respect to capital expenditures for medical care.

G. Political Contributions

Present Law

An individual who itemizes deductions can deduct his or her political contributions up to $100 per year ($200 on a joint return); or al-

ternatively, can claim a credit equal to one-half of his or her political contributions, but not to exceed $25 ($50 on a joint return).

Administration Proposal

The itemized deduction for political contributions would be repealed, but the credit presently allowed for such contributions would be retained.

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III. DESCRIPTION AND DISCUSSION OF ITEMIZED DEDUCTION PROPOSALS

A. State-Local Nonbusiness Gasoline Taxes

Present Law

Under present law, an individual who itemizes deductions can deduct State and local taxes imposed on gasoline, diesel, and other motor fuels not used in business or investment activities—for example, taxes on gasoline consumed in personal use of a family car (sec. 164(a)(5)).

To calculate and substantiate the deduction, taxpayers generally must obtain and keep receipts showing the exact amounts of State and local taxes paid on purchases of motor fuels. With respect to State gasoline taxes, a taxpayer instead may obtain the deductible amount from tables printed in the instructions for Form 1040.[1] The tables are based on the mileage driven by the taxpayer during the year, the number of cylinders in the engine, and the gasoline tax rates in each State. Two or more calculations must be made from the tables if the tax rate in the particular State changed during the year, or if the taxpayer purchased gasoline in States having different tax rates.

Background

Federal income tax law originally allowed deductions for most Federal, State, and local taxes imposed on individuals; however, deductions for Federal income and excise taxes were subsequently repealed. In the Revenue Act of 1964, the Congress adopted the present provision (sec. 164), which generally allows deductions for State and local taxes on income, real and personal property, and gasoline and other motor fuels, plus State and local general sales taxes. Inasmuch as income, property, and general sales taxes were considered the principal sources for State-local tax revenues, the deductibility of these three types of taxes was continued in order to preserve Federal neutrality as to the relative use made of such taxes by State and local governments.

In 1974, the Ways and Means Committee tentatively decided to repeal the itemized deduction for State-local nonbusiness motor fuel taxes, but did not include repeal of the deduction in reporting out its tax reform bill (H.R. 10612) in 1975. In the Senate Finance Committee's reported version of that bill in 1976, this deduction was limited to amounts in excess of $50. However, this proposed limitation on the gasoline tax deduction was deleted on the Senate floor.

H.R. 8444, the National Energy Act, as passed by the House of Representatives on August 5, 1977, would repeal the deduction for nonbusiness motor fuel taxes (based in part on energy conservation grounds). H.R. 5263, the Energy Production and Conservation Tax Incentive Act, as passed by the Senate on October 31, 1977, would not repeal this deduction. The conferees on these energy bills have tenta-

[1] For taxpayers in Hawaii, county gasoline taxes must be calculated from receipts and added to the table amount.

tively decided to delete the House provision repealing the deduction, on the ground that the issue of repeal could be more appropriately considered in the context of general tax legislation.

The District of Columbia and all 50 States, plus counties in Hawaii, impose gasoline taxes at combined State-local rates ranging from 5 to 13½ cents per gallon. All these jurisdictions (except Vermont and Wyoming) also tax diesel fuel, generally at the same rates as gasoline.

State motor fuel taxes totalled $9.1 billion in 1977. Since 1960, State motor fuel taxes have increased from $3.3 billion, but have declined in relative importance as a source of State tax revenues. In 1960, motor fuel taxes were 18.5 percent of all State taxes; by 1970 their share had declined to 13.1 percent, and in 1977, State motor fuel taxes were only 9 percent of all State taxes. Reliance on motor fuel taxes as a source of State tax revenues varies substantially among the States, ranging from 3 percent to 20 percent of total State tax revenues.

It is estimated that deductions for State-local nonbusiness motor fuel taxes totalling $3.4 billion will be claimed on 24.7 million returns for 1978 (the last year before the Administration's proposal would become effective), comprising 91.1 percent of returns filed by itemizers. It is also estimated that 821,000 taxpayers would no longer itemize if this deduction were repealed.

Administration Proposal

The Administration proposal would repeal the deduction for State and local taxes on gasoline, diesel, and other motor fuels not used by the taxpayer in business or investment activities.

Effective date

The Administration proposal would be effective for taxable years beginning after December 31, 1978.

Revenue effect

This proposal would increase calendar 1979 tax liability by $1,151 million.[2]

Members' Proposals

Mr. Jones

Mr. Jones would continue the itemized deduction for State-local motor fuel taxes but would require taxpayers to compute the deduction from receipts showing the exact amounts paid for such taxes; taxpayers could not use tables furnished by the Service to calculate the amount deductible.

Issues

The issues which are discussed in the following section of this pamphlet (III–B) in connection with the Administration proposal to repeal the itemized deduction for nonbusiness general sales taxes also relate to the itemized deduction for State-local nonbusiness motor fuel taxes. These include arguments, for and against deductibility, relating to fiscal accommodation, Federal neutrality, equity among taxpayers, and distributional effect. In addition, there are several issues pertaining particularly to the gasoline tax deduction.

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[2] This estimate is based upon a separate repeal of the gasoline tax deduction. It does not take into account the interaction of proposed tax rate reductions nor of the repeal or change in other itemized deductions.

User-charge argument

Those who favor repeal of the deduction argue that State-local gasoline taxes essentially constitute charges for the use of highways, comparable to the nondeductible Federal gasoline tax. To this extent, these taxes may be viewed as more like personal expenses for automobile travel (as are highway tolls or the cost of gasoline itself) than like income or other general State-local taxes. Under this view, deductibility of the gasoline tax is seen as inconsistent with the user-charge nature of the tax, in that it serves to shift part of the cost from the highway user to the general taxpayer.

Impact on commuters

On the other hand, it has been pointed out that the impact of repealing the deduction would fall more heavily on individuals who commute long distances to work by car (but only if such persons itemize deductions), and who may not have alternative forms of transportation, than on individuals who may use their cars only for non-work related purposes. Similarly, the impact of repeal might fall more heavily on residents of rural areas than on residents of more populated areas, where alternative modes of transportation generally are available.

National energy objectives

The Administration argues that repeal of the deduction would foster national energy objectives. It is debatable whether such repeal would have any significant energy savings impact, because it seems unlikely that consumers would regard elimination of the deduction as more than a modest, if any, increase in the price of gasoline. At the same time, repeal of the deduction arguably could signify the importance of achieving energy conservation goals.

Simplification and administrability

The Administration argues that computing the deduction places recordkeeping burdens on taxpayers or, in the absence of records, may be based on guesswork, and in addition, places audit burdens on the Service. Accordingly, the Administration states that repeal of the deduction would help achieve tax simplification for itemizers, as well as for those taxpayers who would no longer itemize deductions if the Administration proposals to repeal or modify various itemized deductions (including the deduction for nonbusiness motor fuel taxes) were adopted.

Assuming an individual knows the amount of nonbusiness mileage driven during the year (and the tables permit some leeway since they are based on increments of 1,000 miles), derivation of the deduction for State gasoline taxes from the tables does not appear difficult, at least if only one State is involved and the tax rate in that State did not change during the year. It can be argued that this itemized deduction is difficult for the Service to audit, since there is no ready way of gauging the correctness of the amount claimed from data on the return or from easily obtainable records. Any resulting inability or reluctance to challenge the amount claimed, except where there appears to be a gross exaggeration, arguably may lead to mileage estimates by taxpayers which are less than precise.

B. State-Local Nonbusiness Sales Taxes

Present Law

Under present law, an individual who itemizes deductions can deduct State and local sales taxes not related to business or investment activities (sec. 164 (a) (4)). For example, sales taxes paid on items of personal clothing are deductible by itemizers.

To be deductible under this provision, the tax must be a general sales tax—that is, a tax imposed (on sales at retail) at one rate on a broad range of classes of items.[1] In addition, any sales taxes imposed at lower rates on food, clothing, medical supplies, and motor vehicles are deductible (sec. 164(b) (2)).[2] Other sales taxes, such as any selective-rate taxes on sales of alcoholic beverages, tobacco, admissions, or solely on services, generally are not allowable as itemized deductions.

To calculate and substantiate the deduction, taxpayers may obtain and keep receipts showing the exact amount of State and local sales taxes paid during the year. However, most taxpayers who itemize calculate the deductible amount from tables printed in the instructions for Form 1040. The Service develops these tables from studies of expenditures by persons at various income levels.

There is a separate table for each State having general sales taxes. The deductible amount is based on the taxpayer's adjusted gross income plus nontaxable items (such as social security benefits and the deductible portion of long-term capital gains) and on the number of persons in the taxpayer's household.

Local sales taxes are also imposed in various States. An additional amount for local taxes has been built into the table for some of these jurisdictions. For other States having local sales taxes, a further computation must be made after deriving the table amount. Also, taxpayers generally may add to the table amount the actual State and local sales taxes paid on purchases of a boat, airplane, home, car, or truck.

Background

Federal income tax law originally allowed deductions for most Federal, State, and local taxes imposed on individuals; however, deductions for Federal income and excise taxes were subsequently repealed. In the Revenue Act of 1964, the Congress adopted the present provision (sec. 164), which generally allows deductions for State and local taxes on income, real and personal property, and gasoline and other motor fuels, plus State and local general sales taxes. Inasmuch as in-

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[1] The term "general sales tax" also includes compensatory use taxes, i.e., taxes on the use, storage, or consumption of items which would have been subject to a general tax if sold in the State or locality imposing the use tax (sec. 164(b) (2) (D)).

[2] Also, the imposition of a sales tax on the purchase of motor vehicles at a rate higher than the general sales tax rate does not completely preclude deductibility of the specific sales tax. However, the deduction is limited to the rate of the "general" sales tax for the State (sec. 164(b) (2) (E)).

come, property, and general sales taxes were considered the principal sources for State-local tax revenues, the deductibility of these three types of taxes was continued in order to preserve Federal neutrality as to the relative use made of such taxes by State and local governments.

The Congress emphasized concerns other than Federal neutrality with respect to selective sales or excise taxes or fees, such as cigarette or liquor taxes or motor vehicle license fees. It was determined that it was difficult for taxpayers to keep records of these latter taxes, for which tables of estimated amounts could not be developed, and that the deductibility of such taxes varied depending on formalities of State laws. Accordingly, the latter types of taxes or fees were made nondeductible in the 1964 Revenue Act.[3]

The District of Columbia and all States except four (Delaware, Montana, New Hampshire, and Oregon) impose general sales taxes at either the State or local level. (Sales taxes are imposed in Alaska only at the local level.) The combined State-local sales tax rates range from 3 to 8 percent.

State and local general sales taxes for fiscal year 1976 totalled $32 billion, of which $27.3 billion was raised by State taxes and $4.7 billion by local taxes. Overall, general sales taxes constituted 20.4 percent of all State and local tax revenues, with State governments relying on these taxes for 27.3 percent of their tax revenues and local governments for 7 percent. Reliance on State general sales taxes varies substantially among State governments, ranging from less than 20 percent to more than 40 percent of State-level tax revenues.

It is estimated that deductions for nonbusiness general sales taxes totalling $8.5 billion will be claimed on 25.3 million returns for 1978 (the last year before the Administration's proposal would become effective), comprising 93.1 percent of returns filed by itemizers. It is also estimated that 2 million taxpayers would no longer itemize if this deduction were repealed.

Administration Proposal

The Administration proposes to repeal the itemized deduction for State and local general sales taxes not related to business or income-producing activities.

Effective date

The Administration proposal would be effective for taxable years beginning after December 31, 1978.

Revenue effect

This proposal would increase calendar 1979 tax liability by $3,121 million.[4]

Members' Proposals

Mr. Jones

Mr. Jones would continue the itemized deduction for State-local general sales taxes but require taxpayers to compute the deduction from receipts showing the exact amounts paid for such taxes; tax-

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[3] The special rule with respect to sales taxes on motor vehicles at rates higher than the general tax rate was added in 1972 (Public Law 92-580).

[4] This estimate is based upon a separate repeal of the sales tax deduction. It does not take into account the interaction of proposed tax rate reductions nor of the repeal or change in other itemized deductions.

payers could not use tables furnished by the Service to calculate the amount deductible.

Issues

Various arguments have been advanced to justify deductibility of general sales taxes not incurred in business or investment activities; other arguments have been advanced for repeal of the deduction.

Fiscal accommodation

In support of itemized deductions for income, general sales, and property taxes, it is argued that these deductions assist State and local governments to raise revenues to meet their needs, by lessening the economic impact of State-local taxes on individuals who itemize. To the extent that the Federal Government thereby aids State and local governments in raising tax revenues, while foregoing potential Federal revenues which otherwise could be used to meet Federal or State needs, the deduction for State-local taxes may be viewed as an indirect form of revenue sharing.

On the other hand, it is argued that since fewer than 25 percent of individuals now itemize deductions on their Federal income tax returns, it is uncertain whether deductibility of these taxes significantly affects the ability of State and local governments to maintain or increase these taxes. In light of this relatively low percentage of itemizers, it is also argued that deductibility of nonbusiness taxes operates as an inefficient mechanism for revenue sharing. In addition, in 1972 the Congress adopted a program of general revenue sharing grants which go directly to State and local governments, and which may be viewed as lessening the need for indirect revenue sharing through allowance of itemized deductions for nonbusiness taxes.

Federal neutrality

As pointed out by the committee in 1964, in continuing deductibility of nonbusiness general sales taxes, State and local governments rely primarily on income, general sales, and property taxes to raise revenues. It is argued that if the deduction for nonbusiness sales taxes were repealed while the deduction for State income taxes remained, the Federal Government in effect might provide an incentive for States to finance future revenue needs through income taxes, rather than through sales taxes. Thus, if deductibility were repealed for one of the major types of State-local taxes, the Federal Government could be taking what some would view as an inappropriate role in influencing State and local tax policy decisions.

The current extent of this effect is uncertain because of the lower percentage of itemizers at the present time as compared to prior years (the number of itemizers has declined from 41.2 percent in 1965 to about 24 percent in 1977). Moreover, some argue that any shift in State taxes from sales to income would be desirable, since it could result in more progressive State tax systems, although the actual effect of such a shift would depend on the features of the particular sales or income tax systems.

Equity among taxpayers

It is argued that deductibility of general sales taxes is required by the "ability-to-pay" tax principle, since it makes the Federal income

tax apply to an individual's income remaining after he or she has paid such State-local taxes. It is argued that consumers do not have any real choice about paying sales taxes, which reduce the resources available to pay Federal income taxes. Also, it is argued that payment of sales taxes does not constitute a personal expenditure in that the tax proceeds may not be applied in a manner conferring any special benefit on the person paying the tax; it would follow from this argument that such taxes should be deductible in arriving at taxable income.

At the same time, it should be noted that Federal income tax liability is not adjusted for the cost of certain necessary purchases by individuals or for many other factors which may cause cost-of-living differences among residents of different States and areas, including selective sales and excise taxes which may have a similar effect on consumers but are less visible.[5] Also, it is argued by the Administration that allowance of the deduction is inconsistent with the general tax policy that individuals with equal income should pay the same tax regardless of how they spend their income for personal purposes—e.g., whether for taxable or nontaxable items.

Simplification and administrability

The Administration estimates that repeal of this deduction would reduce the number of individuals who itemize by 2.3 million (and that repeal of deductions for certain other State-local taxes as proposed by the Administration would further reduce itemizers by an additional 1.5 million). It is argued that repeal also would accomplish simplification because itemizers would be relieved of recordkeeping and computational complexities with respect to nonbusiness sales taxes, the Service would be relieved of audit burdens, and definitional or other controversies concerning the tax would be eliminated (e.g., whether a particular sales tax qualifies as a "general" tax). Also, in the case of persons who would no longer elect to itemize, both taxpayers and the Service would be freed of complexities involved in all the allowable itemized deductions (medical care, casualty loss, etc.).

Those who favor retaining the deduction, on the other hand, argue that tax simplification is a desirable objective, and that the simplification argument could be made for the repeal of any itemized deduction, but that the reasons for retaining the deduction are sufficiently compelling to justify any additional complexity it may cause. Also, while several steps may be required to derive the deductible amount using the IRS tables (for example, nontaxable income must be added to adjusted gross income, and some taxpayers must make computations involving multiplication), these problems at least involve less difficulty than keeping receipts for each taxable purchase and then totalling them for the year.

Distributional effect

Those who support repeal of the sales tax deduction point to the effect of the deduction on the incidence of the sales tax. The deduction

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[5] It also has been argued that differences among States and localities in sales tax rates might influence migration of households and businesses. Availability of the sales tax deduction reduces the effective differences, although this effect is limited to those taxpayers who itemize deductions.

makes the impact of State and local sales taxes more regressive because (as in the case of any itemized deduction) higher income, high-bracket taxpayers receive a larger offset than lower income, low-bracket taxpayers.

Alternatively, it could be argued that the sales tax deduction is necessary for the reasons cited above, and that the overall progressivity of the Federal income tax can be adjusted more directly through the rate schedules.

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C. State-Local Nonbusiness Personal Property Taxes

Present Law

Under present law, an individual who itemizes deductions can deduct certain State and local taxes imposed on personal property which is neither used in a trade or business nor held for production of income (sec. 164(a)(2)). For example, itemized deductions are allowed for personal property taxes imposed, in some States, on automobiles, motorcycles, and boats used exclusively for personal purposes.

To be deductible under this provision, the tax must be imposed on personal property, must be an ad valorem tax (assessed in proportion to the property's value), and must be imposed on an annual basis. Automobile registration fees meeting these three criteria are deductible in full. Registration fees based partly on value and partly on other criteria (such as weight or engine cylinders) may be deductible in part.

Background

Federal income tax law originally allowed deductions for most Federal, State, and local taxes imposed on individuals; however, deductions for Federal income and excise taxes were subsequently repealed. In the Revenue Act of 1964, the Congress adopted the present provision (sec. 164), which generally allows deductions for State and local taxes on income, real and personal property, and gasoline and other motor fuels, plus State and local general sales taxes. Inasmuch as income, property, and general sales taxes were considered the principal sources for State-local tax revenues, the deductibility of these three types of taxes was continued in order to preserve Federal neutrality as to the relative use made of such taxes by State and local governments.

The District of Columbia and all States except four (Delaware, Hawaii, New York, and Pennsylvania), or their subdivisions, impose personal property taxes on one or more types of tangible personalty. The types of property subject to tax may include commercial, industrial, agricultural, household, and motor vehicle. There are wide variations among these jurisdictions as to the classes of property which are taxable. In some States, household goods and personal effects are fully taxable, as well as commercial property; in others, there are dollar exemptions for some but not all assets; and in others, personal goods are wholly exempt. In addition, some States (or their subdivisions) impose personal property taxes on intangible personalty, such as securities, notes, accounts receivable, and beneficial interests in trusts.

It is estimated that deductions for nonbusiness personal property taxes totalling $946 million will be claimed on 10.9 million returns for 1978 (the last year before the Administration's proposal would become effective), or 40.1 percent of returns filed by itemizers. It is also estimated that 204,000 taxpayers would no longer itemize deductions if this deduction were repealed.

Administration Proposal

The Administration proposal would repeal the itemized deduction for State and local personal property taxes imposed on property which is not held for business or income-production purposes.

Effective date

The Administration proposal would be effective for taxable years beginning after December 31, 1978.

Revenue effect

This proposal would increase calendar 1979 tax liability by $320 million.[1]

Issues

The issues which are discussed in the preceding section of this pamphlet (III–B) in connection with the Administration proposal to repeal the itemized deduction for nonbusiness general sales taxes also relate to the itemized deduction for State-local nonbusiness personal property taxes. These include arguments, for and against deductibility, relating to fiscal accommodation, Federal neutrality, equity among taxpayers, and distributional effect. In addition, there are several issues pertaining particularly to the personal property tax deduction.

Simplification and administrability

Apart from considerations of simplification and administrability as discussed in the preceding section of this pamphlet (III–B), it also can be argued that repeal of the deduction for nonbusiness personal property taxes would eliminate confusion caused by the fact that there are differing rules among the States as to the imposition of taxes or fees in connection with registering motor vehicles. In some States, automobile registration fees are deductible in full because the tax is based solely on value; in other States, only in part because part of the tax is based on value and part on other factors; and in the remaining jurisdictions, not at all because the registration tax is not based on value. Thus, some simplification might be accomplished through repeal of the deduction as proposed by the Administration. The Administration also states that the existing deduction may encourage State and local governments to impose deductible ad valorem taxes on automobiles in lieu of nondeductible fees, and contends that there is no Federal policy reason to influence the type of automobile taxes or fees to be imposed for State and local revenue-raising purposes.

Impact on States

While viewing tax simplification as a desirable objective, those favoring deductibility argue that repeal of the deduction for nonbusiness personal property taxes would have inequitable effects because of the wide variations among taxing jurisdictions as to the types of property subject to the tax. Thus, for example, itemizers in jurisdictions where personal property taxes fall on household goods or on automobiles would lose their deductions, while persons in jurisdictions

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[1] This estimate is based upon a separate repeal of the personal property tax deduction. It does not take into account the interaction of proposed tax rate reductions nor of the repeal or change in other itemized deductions.

which tax only business or commercial assets could continue to deduct such taxes as trade or business expenses.

Also, it is argued that personal property taxes on household goods may operate as a supplement to the jurisdiction's real property tax system. That is, less revenues need to be raised from real estate taxes if revenues are raised through personal property taxes (which fall on renters, as well as on homeowners). Accordingly, some argue that the deduction for nonbusiness personal property taxes should be retained as long as real estate taxes on residences remain deductible.

D. State Unemployment Disability Fund Taxes

Present Law

Under the laws of four States (California, New Jersey, New York, and Rhode Island), employers must withhold from wages paid to employees amounts which are used to finance State unemployment disability funds. These funds typically provide disability benefits based on wages (and in California, certain hospital benefits) if an eligible individual becomes unemployed as a result of illness or injury which is not job-related and hence not otherwise compensable under workers' compensation laws. For example, benefits would be payable if the employee became unable to work by virtue of disabilities resulting from an accident incurred in leisure activities.

Under the California, New York, and New Jersey statutes, an employer may establish a private disability benefits plan, through insurance or self-insurance, in lieu of the State program. The plan cannot require employee contributions greater than those required to be paid to the State fund (in California, for example, the maximum employee State fund contribution for 1977 was $114).

The Internal Revenue Service ruled, in 1975, that such employee payments were not deductible as trade or business expenses or as taxes.[1]

The U.S. Tax Court has rejected the Service's position, holding in two cases that such payments are deductible as State income taxes (or, in the alternative, as employee trade or business expenses).[2] The Service has announced [3] that it will follow these decisions and permit itemized deductions for amounts withheld from employee wages and paid to State unemployment disability funds under the laws of the States listed above. However, employee contributions to private employer disability plans would continue to be treated as nondeductible.

Background

In several rulings issued in the 1940's, the Internal Revenue Service had determined that amounts withheld from employee wages as contributions to State unemployment disability funds were deductible as taxes. However, in its 1975 rulings, the Service took the position that such mandatory contributions were nondeductible personal expenses in the nature of disability insurance premiums.

The Service apparently concluded that this change in position was required by amendments to section 164 of the Code made by the Revenue Act of 1964. Prior to these changes, the Code permitted deductions for all State and local taxes except for certain taxes specifically listed as nondeductible. Pursuant to the 1964 Act, the Code allows

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[1] Rev. Rul. 75–48, 1975–1 CB 62; Rev. Rul. 75–148, 1975–1 CB 64; Rev. Rul. 75–149, 1975–1 CB 64.

[2] *James R. McGowan*, 67 T.C. 599 (1976) (Rhode Island); *Anthony Trujillo*, 68 T.C. 670 (1977) (California).

[3] Internal Revenue News Releases IR–1742 (January 28, 1977) and IR–1967 (March 10, 1978).

deductions only for specifically enumerated State-local income, general sales, property, and motor fuels taxes and for any other State, local, or foreign taxes paid or incurred in carrying on a trade or business or investment activity.

In considering whether employee taxes for nonoccupational disability benefits should be treated as deductible business expenses or nondeductible personal expenses, the Service looked to the ultimate purpose of the State funds and concluded that the taxes are incurred to provide indemnity coverage for loss of wages due to unemployment resulting from nonoccupational hazards rather than from hazards arising from business contingencies. Under this view, the Service ruled in 1975 that such employee payments were not deductible as taxes, as trade or business expenses, or as medical expenses. The Service likewise ruled that employee contributions to private insurance plans established by employers as substitutes for coverage through State disability benefit funds are nondeductible personal expenses.

The Tax Court, however, has concluded that mandatory contributions to State funds are deductible as income taxes, inasmuch as the employee's payments are measured as a percentage of his or her wages. The Court analogized these State-mandated contributions to the FICA employment tax on employees under section 3101 (the latter tax is expressly made nondeductible for Federal income tax purposes by section 275). In the alternative, the Court held that State unemployment disability taxes would be deductible under section 162 as employee trade or business expenses.

As indicated above, the Service has announced that it will treat amounts withheld from employee wages under the unemployment disability statutes enacted by the four States listed above as taxes deductible by itemizers if such amounts are paid over to the State fund, but will continue to treat employee payments to nonoccupational disability plans established by employers pursuant to such statutes as nondeductible.

In 1974, the Ways and Means Committee tentatively decided to disallow deductions for unemployment compensation, disability, or similar taxes imposed on employees. However, the committee did not include repeal of the deduction in reporting out its tax reform bill (H.R. 10612) in 1975.

Administration Proposal

Deductions for employee contributions to State unemployment disability funds or to private employer plans established in lieu thereof would be disallowed.

As under present law, however, itemized deductions would be allowed for amounts withheld from employee wages as contributions to State funds providing unemployment benefits to persons unemployed otherwise than because of disability from nonoccupational hazards.[3] Also, amounts required to be paid by employers to State unemployment compensation or unemployment disability funds would continue to be deductible as under present law.[4]

Effective date

The Administration proposal would be effective for taxable years beginning after December 31, 1978.

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[3] See Rev. Rul. 71–73, 1971–1 CB 52; Rev. Rul. 75–156, 1975–1 CB 68.
[4] See, e.g., Rev. Rul. 75–48, *supra*.

Issues

The Administration argues that it is inequitable to permit deductions to individuals in a few States where they acquire disability insurance through State programs, while deductions are not allowed to individuals in States where they can acquire coverage only through private insurance.

Thus, deductibility of such contributions may be viewed as unfair to employees in the great majority of States, or non-employees in all States, who are not allowed deductions for the cost of insuring for disability benefits similar to those provided by State unemployment disability funds.

On the other hand, the Tax Court has viewed these State-fund contributions as State "income taxes," or, in the alternative, as employee trade or business expenses deductible by itemizers.

E. Taxes Paid in Connection With Capital Assets

Present Law

Under present law, a taxpayer can deduct, in the year paid or incurred, certain State, local, and foreign taxes, even if such taxes are incurred on acquisition of a capital asset (sec. 164(a)). For example, in the year the taxes are paid or incurred, an independent contractor constructing a building can deduct sales taxes on purchase of building materials, an attorney can deduct sales taxes on law books purchased for her or his practice, and an investor can deduct transfer taxes on the purchase of securities or real estate.

Pursuant to the Tax Reform Act of 1976, real property taxes attributable to the "construction period" of a building must be capitalized in the year paid or incurred and, subject to certain transitional rules, must be amortized over a 10-year period (sec. 189).[1]

Background

In the Revenue Act of 1964, the Congress enumerated certain taxes—including State and local taxes on income, real and personal property, and motor fuels, plus State and local general sales taxes—which are deductible in the year paid or incurred. In addition, the Congress added a provision (the last sentence of section 164(a)) to make clear that State, local, and foreign taxes not otherwise enumerated in section 164(a) may be taken as itemized deductions "when they are of a business nature or for the production of income even though otherwise they might have to be capitalized."[2]

In 1974, the Ways and Means Committee tentatively agreed to eliminate itemized deductions for stock or other property transfer taxes paid in connection with investment activities; these taxes instead would be included in the basis of the property acquired. The committee did not include repeal of deductibility of such transfer taxes in reporting out its tax reform bill (H.R. 10612) in 1975.

Administration Proposal

As discussed above, deductions for State-local nonbusiness motor fuel, general sales, and personal property taxes would be repealed. State, local, and foreign income taxes and real property taxes would continue to be deductible in the year paid or incurred (except that construction period real property taxes would continue to be capitalized as under current law). Business-related or investment-related taxes would have to be capitalized, rather than being fully deductible

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[1] Under present law, special accounting rules apply with respect to taxes (except income taxes) otherwise allowable as current deductions if (1) such taxes are treated as indirect production costs includible as "inventoriable costs" or (2) such taxes are treated as indirect costs allocable to certain "long-term contracts." See Treas. Regs. secs. 1.471–11(c)(2) and 1.451–3(d)(5).

[2] H. Rep. 749, 88th Cong., 1st Sess. 50 (1963).

in the year paid or incurred, if incurred on acquisition of a capital asset.[3]

Effective date

The Administration proposal would be effective for taxable years beginning after December 31, 1978.

Issues

The Administration argues that allowance of current deductions for taxes related to acquisition of capital assets violates the general tax principle that the costs of a capital asset should be recovered through depreciation over the asset's life or through deduction of costs from proceeds on disposition of the assets.

The committee may wish to consider whether taxes related to acquisition of a capital asset are asset costs. It can be argued, for example, that the cost of a capital asset should not include acquisition-related taxes because such taxes are imposed on the transaction and not on the asset, even though purchase price is used to measure the amount of tax imposed. Additionally, it is argued that an asset purchased in a jurisdiction which has a higher rate of tax is no more valuable than the same asset purchased in a jurisdiction with a lower rate of tax, and thus the cost basis of the asset should not be increased by the amount of the acquisition-related taxes.

Alternatively, it can be argued that acquisition-related taxes, like other indirect expenses incurred in connection with acquiring an asset (e.g., transportation and set-up costs), constitute a cost of the asset and hence should be capitalized and recovered through the annual allowance for depreciation, or through deduction from proceeds on disposition of the asset.

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[3] The Administration proposal would not modify the special accounting rules described in note 1, *supra*.

F. Medical Expenses and Casualty Losses

Present Law

(a) Medical expenses

Under present law, an individual who itemizes deductions generally can deduct unreimbursed medical and dental expenses paid for the medical care [1] of the individual, and his or her spouse and dependents, to the extent that the total of such expenses exceeds 3 percent of adjusted gross income (sec. 213). Amounts paid for medicine and drugs may be counted toward the deductible amount only to the extent exceeding one percent of adjusted gross income.

In addition, one-half the amount of medical insurance premiums (up to $150) can be deducted by itemizers without regard to the 3-percent limitation. The balance of medical insurance premiums is added to other medical expenses and is subject to the 3-percent limitation.

A capital expenditure made for the primary purpose of medical care may qualify for the deduction. Thus, a capital expenditure that is related only to needed medical care, and is not related to permanent improvement of property, is deductible.

In addition, a capital expenditure for permanent improvement of property, if also directly related to medical care, may qualify for the medical expense deduction to the extent the value of the improvement exceeds the resulting increase in the value of the related property. For example, a recent decision of the U.S. Tax Court held that $82,000 of the total cost ($194,000) of a swimming pool added to a residence was deductible as a medical expense, since the taxpayer's physician had recommended that the taxpayer install a home pool and use it twice daily for the rest of her life to prevent permanent paralysis from injuries to her spinal cord.[2]

(b) Casualty losses

Under present law (sec. 165(c)), an individual who itemizes can deduct unreimbursed losses of nonbusiness property arising from fire, storm, shipwreck, or other casualty, or from theft (any such casualty or theft hereafter being referred to as "casualty"). The amount of the loss equals the lower of (1) the fair market value of the property immediately before the casualty, reduced by the fair market value of the property immediately after the casualty (zero in the case of a theft), or (2) the property's adjusted basis, less insurance recoveries. Further,

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[1] The term "medical care" means amounts paid for (1) diagnosis, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body; (2) transportation primarily for, and essential to, such medical care; or (3) insurance covering medical care (including amounts paid as premiums under part B of title XVIII of the Social Security Act, relating to supplementary medical insurance for the aged).

[2] C. H. Ferris, 36 CCH Tax Ct. Mem. 765 (1977).

the deduction is allowed for any one casualty only to the extent that the amount of the loss, as so computed, exceeds $100.

Background

(a) Medical expenses

Medical expenses have been allowed as itemized deductions since 1942, generally on the rationale that "extraordinary" medical costs—those over a floor designed to exclude predictable, recurring expenses—reflect an economic hardship, beyond the individual's control, which reduces the ability to pay Federal income tax. Initially, the floor was set at 5 percent of the taxpayer's net income, in the belief that ordinary medical expenses on the average did not exceed that amount. In 1944, the floor was modified to be 5 percent of adjusted gross income, and in 1954, was reduced to 3 percent of adjusted gross income.

The one-percent floor on medicine and drugs is intended to serve as an administratively convenient means of excluding from the deduction calculation ordinary drugstore purchases such as aspirin and bandages.

At the time the 1954 Code was enacted, an upper limit was placed on the deduction, in addition to the current 3-percent floor. The ceiling was $5,000 for single taxpayers; $10,000 for joint returns, heads of households, and surviving spouses; and for others, $2,500 times the number of exemptions (other than those for age and blindness). Taxpayers 65 or older were exempt from the 3-percent floor, but subject to the applicable ceiling limitation.

Various modifications in the medical expense deduction have been made since 1954. The Social Security Amendments of 1965 made the following significant changes:

(1) the ceilings on the amounts deductible were removed, because the Congress felt that upper limits would deny appropriate deductions in extreme hardship cases;

(2) the exemption from the 3-percent floor for taxpayers age 65 or over was repealed, in light of enactment of Medicare and to simplify the law by having a uniform floor; and

(3) the special deduction for a portion of medical insurance premiums was added, in order not to discourage persons from insuring against medical costs.

In 1974, the Ways and Means Committee tentatively decided, in order to limit deductions to extraordinary medical expenses and to simplify the deduction, that the deduction floor should be increased from 3 percent to 5 percent of adjusted gross income. The separate one-percent floor for medicine and drugs would have been eliminated, but only amounts paid for prescription drugs or insulin would count as medical expenses. The committee also tentatively agreed to eliminate the separate deduction, outside the 3-percent floor, for one-half of medical insurance premiums. These tentative modifications were not included in the tax reform bill (H.R. 10612) as reported out by the committee in 1975.

It is estimated that in 1978 (the last year before the Administration's proposal would become effective), medical expense deductions totaling $11.2 billion will be claimed on 11.1 million tax returns, or 72.2 percent of those filed by itemizers.

(*b*) *Casualty losses*

Since the inception of the income tax laws, individuals who itemize have been permitted to deduct casualty losses to the extent not covered by insurance. Initially, such losses were deductible in full. In 1964, the Treasury Department recommended that aggregate casualty losses be deductible only to the extent exceeding 4 percent of adjusted gross income. While not accepting that approach, the Congress (in the Revenue Act of 1964) imposed the current $100 floor per casualty occurrence, in order to limit deductibility to extraordinary, nonrecurring losses which are not part of day-to-day living. The $100 per occurrence floor was selected because it corresponded with the "$100 deductible" insurance then carried by many individuals with respect to casualty losses.

Under the Ways and Means Committee tentative decisions in 1974, casualty losses would have been deductible only to the extent exceeding $50 per occurrence. In addition, the total of such excess amounts would have been deductible only to the extent exceeding 3 percent of adjusted gross income. These tentative modifications in the deduction were not included in the tax reform bill (H.R. 10612) as reported by the committee in 1975.

It is estimated that some 1.8 million returns for 1978 (the last year before the Administration's proposal would become effective), or 6.5 percent of returns filed by itemizers, will claim casualty loss deductions aggregating $1.5 billion.

Administration Proposal

The Administration proposal would combine the deduction for medical expenses with the deduction for casualty losses. Medical expenses and casualty losses would be deductible only to the extent that, in the aggregate, they exceed 10 percent of adjusted gross income. As under present law, a casualty loss would be taken into account only to the extent exceeding $100 for any occurrence.

Both the separate partial deduction for medical insurance premiums and the special one-percent floor for medicine and drug expenditures would be repealed. Thus, medical insurance premiums and expenses for medicine and drugs would be treated like other medical care expenses, subject to the general 10-percent floor for the combined medical and casualty deduction.

The definition of medical care expenses qualifying for the deduction would be amended so that the cost of facilities, services, and devices would be deductible only if they are of a type customarily used primarily for medical purposes and are in fact intended primarily for medical use of the taxpayer or a dependent.

Effective date

The Administration proposal with respect to deductions for medical expenses and casualty losses would be effective for taxable years beginning after December 31, 1978.

Revenue effect

This proposal would increase calendar 1979 tax liability by $2,583 million.[3]

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[3] This estimate is based upon the separate revision of the medical and casualty loss deductions. It does not take into account the interaction of proposed tax rate reductions nor of the repeal or change in other itemized deductions.

Members' Proposals

(a) Medical expenses

Mr. Rostenkowski and Mrs. Keys

Mr. Rostenkowski and Mrs. Keys would revise current law by eliminating the separate partial deduction for medical insurance premiums and by eliminating the one-percent floor for medicine and drugs. Nonprescription medicine and drugs other than insulin would not qualify as deductible expenses.

Mr. Martin

Mr. Martin would replace the current deduction with a refundable tax credit equal to the sum of (1) 85 percent of medical expenses in excess of 15 percent of the taxpayer's "modified adjusted gross income" and (2) 100 percent of medical expenses in excess of 25 percent of "modified adjusted gross income." "Modified adjusted gross income" would equal adjusted gross income reduced by the amount of the taxpayer's personal exemptions, and increased by the amount of the taxpayer's excluded capital gains and tax-exempt interest.

(b) Casualty losses

Mr. Jones

Mr. Jones would revise current law by changing the current floor on deductible casualty losses from $100 per occurrence to a floor, for aggregate casualty losses during the year, of $500 per return.

Issues

(a) Medical expense deduction

The committee may wish to consider various proposals which have been suggested for simplifying or otherwise modifying the medical expense deduction.

Percentage floor.—The basic rationale for permitting certain medical care expenses as itemized deductions, rather than treating all such expenses as nondeductible personal expenses, is that extraordinary medical expenses are considered a hardship which involuntarily reduces the individual's ability to pay taxes. When the current percentage floor was adopted in 1954, it was estimated that on the average 3 percent of income was spent for medical care. It is argued by the Administration that since expenditures for medical care now average about 8 percent, the floor for distinguishing ordinary from extraordinary medical costs plus casualty losses should be raised to 10 percent.

Floor on drugs.—The Administration argues that the separate one-percent floor for drugs and medicine adds complexity to the deduction computation and should be eliminated. If this approach were adopted, medicine and drugs eligible for the deduction could be limited to prescription drugs and insulin. This limitation would be intended to deny deductions for ordinary items such as headache remedies and cough medicine, which are effectively excluded from the deduction under current law through the one percent floor.

Insurance premiums.—It has been suggested that the special rule permitting partial deduction, outside the 3 percent floor, of medical insurance premiums should be eliminated to reduce computational problems. It is argued that this rule is inconsistent with the basic

rationale for the medical care deduction, since payment of such premiums are not extraordinary or unavoidable expenditures. On the other hand, it is argued that denial of the partial deduction might discourage some itemizers from purchasing such insurance.

Capital expenditures.—It has been suggested that the allowance of deductions for capital expenditures has caused complexity and should be subject to some limitation. The Administration argues that expenditures for facilities, services, and devices should be deductible as medical expenses only if they are of a type customarily used primarily for medical purposes and are in fact intended primarily for medical use. The committee may wish to consider whether it is feasible to draw clear statutory lines which would deal effectively with the many factual situations which may arise in this regard or whether the IRS and the courts will be able adequately to interpret the current statutory provisions, and whether the issue of appropriate rules for deducting such capital expenditures should be addressed in the future as part of a general review of all aspects of qualifying medical expenses.

(*b*) *Casualty losses*

The committee may wish to consider various proposals which have been suggested for simplifying or otherwise modifying the casualty loss deduction.

Dollar floor.—The $100 floor in current law serves not only to exclude some predictable, ordinary losses, but also to eliminate what might be a multitude of hard-to-audit small claims (for example, a claim of $35 damage to shrubbery from a rainstorm). It has been suggested that a more effective way to distinguish ordinary from extraordinary casualty losses might be to adopt the approach used for the medical expense deduction—i.e., to use a floor based on a percentage of the taxpayer's adjusted gross income.

If this approach were adopted, the new percentage floor could be applied to the sum of any qualifying casualty losses each of which exceeded a flat dollar floor. The purpose of retaining a per-occurrence floor would be for administrative and audit simplification.

The two floors in combination would serve to eliminate trivial deductions, and to refine the extraordinary-ordinary loss distinction by relating it to a percentage of adjusted gross income. A two-floor approach would increase computational complexity for those taxpayers entitled to itemize casualty losses. However, that approach could achieve simplification by reducing the number of taxpayers claiming such deductions while still eliminating, with respect to itemizers having large casualty losses, any deduction for small, hard-to-verify claims.

On the other hand, the staff of the Subcommittee on Oversight of the Committee on Ways and Means has suggested that if a percentage floor were adopted, consideration should be given to eliminating the current per-occurrence floor in order to simplify the deduction and reduce taxpayer computation errors.

(*c*) *Proposed combined floor*

The Administration argues that the proposed combination of the deductions for medical care expenses and casualty losses with a 10-percent floor would limit such deductions, as originally intended, to extraordinary circumstances and would achieve significant simplifica-

tion. The Administration estimates that adoption of its proposed "hardship deduction" would reduce the number of taxpayers who itemize medical expenses and nonbusiness casualty losses under present law by 11.1 million, or 83 percent. Also, the Administration estimates that as a result of the changes, some 2.3 million taxpayers would no longer itemize deductions.

It is argued that for taxpayers who would continue to itemize other deductions, simplification would be achieved through elimination of recordkeeping and calculation complexities associated with the current medical expense deduction, although taxpayers close to the deduction floor would, as a practical matter, have to maintain records and make trial computations. The casualty loss deduction has been a source of numerous complexities, including disputes over the definition of occurrences triggering deductible losses and over the fair market value of property involved.

Those who favor retention of the current separate deductions for medical expenses and casualty losses would argue that while there are considerable complexities involved for each of these deductions, they should be retained (perhaps subject to some simplification modifications) in light of the basic policy that income which in effect has been involuntarily converted into a medical cost or casualty loss does not reflect a true increase in the taxpayer's net worth and hence should not be subject to tax. Also, extraordinary medical expenses or casualty losses may significantly impair the individual's ability to pay income taxes. Further, it could be argued that simplification, if desired, should be achieved through modifications in the medical expense computation or floor and through adoption of a percentage-of-income floor for the casualty loss deduction. In addition, those who favor retention of the current separate deductions would argue that a convincing rationale for combining medical expenses and casualty losses into one deduction does not seem to have been advanced.

G. Political Contributions

Present Law

Under present law (sec. 218), an individual who itemizes deductions can deduct political or newsletter fund contributions up to $100 per year ($200 in the case of a joint return). Contributions eligible for the deduction may be made to (1) candidates for nomination or election to Federal, State, or local office in general, primary, or special elections; (2) committees sponsoring such candidates; (3) national, State, or local committees of a national political party; or (4) newsletter funds of an official or candidate.

Alternatively, a taxpayer can elect an income tax credit equal to one-half of such political and newsletter fund contributions, but not more than $25 ($50 in the case of a joint return) (sec. 41). The credit cannot exceed the taxpayer's income tax liability as reduced by the sum of any credits claimed for foreign taxes, for the elderly, and for investments in certain property.

An individual who does not itemize deductions can utilize the tax credit. If an individual itemizes and makes political contributions of $50 or less ($100 on a joint return), the credit generally will result in a greater tax benefit than the deduction, unless the contributor's marginal tax bracket is in excess of 50 percent. For contributions of $100 or more ($200 or more on a joint return), the itemized deduction will result in a greater tax benefit than the credit, unless the contributor's tax bracket is less than 25 percent. To determine whether the credit or deduction will produce the greater tax benefit if a $50–$100 contribution is made ($100–$200 in the case of a joint return), taxpayers must calculate their tax both ways. The result will depend on the amount of the contribution, other items on the return, and the taxpayer's marginal income tax bracket.

Background

Enacted in the Revenue Act of 1971, these provisions were intended to encourage citizens to participate more actively in the elective process. It was thought that these limited tax incentives would reduce the dependency of candidates on large contributions and special interest groups, by encouraging relatively small private contributions, and thereby would increase the base of political financing.[1]

The maximum deduction allowed for political contributions initially was limited to $50 ($100 for a joint return), and the maximum credit to $12.50 ($25 for a joint return). In 1975, these amounts were increased to the present limitations by Public Law 93–625, which also made newsletter fund contributions eligible for the deduction or credit.

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[1] Apart from the political contribution deduction/credit provisions, the Federal Election Campaign Act allows a taxpayer to earmark $1 ($2 on a joint return) of his or her Federal income tax liability for contribution to the public financing of Presidential campaigns.

It is estimated that deductions for political contributions will be claimed on 751,000 returns filed by individuals who itemize deductions for 1978 (the last year before the Administration's proposal would become effective), or about 2.8 percent of returns filed by itemizers. In addition, the alternative credit is estimated to be claimed on about 1.7 million 1978 returns.

Administration Proposal

The Administration proposal would repeal the itemized deduction for political contributions, while retaining the present tax credit.

Effective date

The Administration proposal would be effective for taxable years beginning after December 31, 1978.

Revenue effect

This poposal would increase calendar 1979 tax liability by $3 million.

Issues

The Administration, in addition to questioning whether allowance of the deduction or credit has any significant effect on the level of political contributions, indicates that the deduction allows high-bracket taxpayers to make the same dollar contribution at less economic cost than low-bracket taxpayers. For example, married individuals in the 68-percent marginal tax bracket who contribute $200 would receive a tax benefit of $136 if they itemize deductions, but would receive a tax benefit of only $50 if they did not itemize and elected the credit. The Administration points out that repealing the optional deduction for political contributions would eliminate this difference in tax treatment.

The committee may wish to consider the possible effect that repealing the itemized deduction for political contributions might have on the level of such contributions. One study, for example, has asserted that tax incentives have not had a significant impact on the level of political contributions, and that such incentives provide tax benefits for relatively high-income individuals who would make such contributions regardless of the incentives availability.[2] On the other hand, it can be argued that the deduction does encourage some taxpayers to make contributions which they otherwise would not make. Accordingly, if repeal of the deduction were viewed as tending to reduce the number of persons making political contributions, the committee may wish to consider increasing the maximum dollar limit of the remaining credit.

Another consideration which the committee may wish to take into account in reviewing the Administration proposal is that availability of both the deduction and the credit tends to favor high-bracket individuals who itemize their deductions over low-bracket individuals who itemize, as well over individuals who do not itemize deductions. However, although a tax credit for political contributions may be

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[2] D. Adamany & G. Agree, *Political Money* 125–128 (1975). This study was based in part upon data compiled in the Twentieth Century Fund Survey, along with data provided by the Internal Revenue Service and the States of California and Oregon, which provide State income tax incentives for political campaign contributions.

of equal value to all taxpayers regardless of their marginal tax bracket, the committee may wish to consider this fact in light of the basic principle of tax equity that tax burdens should vary with ability to pay; as a corollary to that rule, the tax benefit of a deduction increases in value as income tax brackets increase.

Simplification and administrability

The committee may also wish to consider the argument that the availability of a deduction in addition to the credit tends to complicate the tax system both by requiring additional instructions, lines on the tax form, and rules for ordering credits. Moreover, as a practical matter, many taxpayers may have to calculate their tax liability both ways to determine which option would produce the greater tax benefit. This tends to complicate the tax system and to foster unnecessary calculations.

APPENDIX: DISTRIBUTIONAL IMPACT OF ADMINISTRATION PROPOSALS REGARDING CERTAIN ITEMIZED DEDUCTIONS

The following tables show the revenue effect by expanded income class of the Administration proposed repeal of certain tax deductions and changes to the medical and casualty deductions. Each table shows the effect of making the proposed change versus present law. In the event that additional itemized deduction changes are adopted or the tax rates are changed, the revenue increases shown here would be reduced by the "interaction" of those changes. Lowering tax rates would directly reduce the benefit of itemized deductions and hence the revenue increase from their repeal. Repeal of one itemized deduction would cause some formerly itemizing returns to switch to the zero bracket amount (standard deduction). This would remove these returns from contributing to the tax increase from the repeal of other itemized deductions.

It should be noted that these tables show distributional effects estimated at 1978 income levels, the most recent data available. Because the Administration proposals described in this pamphlet are proposed to be effective for taxable years beginning after December 31, 1978, the revenue effects for future calendar and fiscal years resulting if these proposals are implemented would differ from those shown in the tables. These tables offer a consistent full-year view at 1978 income levels of the proposed changes.

Table 1.—Distribution of the Administration's Proposed Repeal of the State and Local Gasoline Tax Deduction as Compared to Present Law

[1978 income level]

Expanded income class[1] (thousands)	Returns with tax increase (thousands)	Returns with tax increase as a percent of— Returns itemizing	All returns	Amount of tax increase (millions)	Percentage distribution of tax increase	Average tax increase
Below $5	94	21.8	0.4	$1	0.1	$16
$5 to $10	1,522	68.3	7.9	26	2.7	17
$10 to $15	3,796	89.5	26.9	90	9.2	24
$15 to $20	5,070	94.1	43.7	150	15.4	30
$20 to $30	7,976	96.4	61.5	328	33.7	41
$30 to $50	4,734	96.7	81.1	276	28.3	58
$50 to $100	1,201	92.1	84.0	81	8.3	67
$100 to $200	253	88.8	84.6	17	1.7	69
$200 & over	65	85.5	83.3	5	.5	82
Total	24,712	91.1	27.9	975	100.0	39

[1] Expanded income equals adjusted gross income plus minimum tax preferences less investment interest expense to the extent of investment income.

Note—Details may not add to totals because of rounding.

Table 2.—Distribution of the Administration's Proposed Repeal of the State and Local Sales Tax Deduction as Compared to Present Law

[1978 income level]

Expanded income class [1] (thousands)	Returns with tax increase (thousands)	Returns with tax increase as a percent of— Returns itemizing	All returns	Amount of tax increase (millions)	Percentage distribution of tax increase	Average tax increase
Below $5	121	28.0	0.5	$2	0.1	$14
$5 to $10	1,701	76.3	8.9	45	1.7	26
$10 to $15	3,943	92.9	28.0	172	6.5	44
$15 to $20	5,119	95.0	44.1	316	12.0	62
$20 to $30	8,007	96.7	61.7	762	28.8	95
$30 to $50	4,767	97.3	81.7	791	29.9	166
$50 to $100	1,259	96.5	88.1	380	14.4	302
$100 to $200	277	97.2	92.6	124	4.7	447
$200 & over	73	96.1	93.6	52	2.0	718
Total	25,268	93.1	28.6	2,645	100.0	105

[1] Expanded income equals adjusted gross income plus minimum tax preferences less investment interest expense to the extent of investment income.

NOTE—Details may not add to totals because of rounding.

Table 3.—Distribution of the Administration's Proposed Repeal of the State and Local Personal Property Tax Deduction as Compared to Present Law

[1978 income level]

Expanded income class [1] (thousands)	Returns with tax increase (thousands)	Returns with tax increase as a percent of— Returns itemizing	All returns	Amount of tax increase (millions)	Percentage distribution of tax increase	Average tax increase
Below $5	39	9.0	0.2	(2)	(2)	$7
$5 to $10	623	27.9	3.3	$6	2.1	10
$10 to $15	1,708	40.3	12.1	22	7.6	13
$15 to $20	2,225	41.3	19.2	33	11.4	15
$20 to $30	3,517	42.5	27.1	82	28.3	23
$30 to $50	2,103	42.9	36.0	77	26.6	37
$50 to $100	511	39.2	35.8	37	12.8	73
$100 to $200	110	38.6	36.8	17	5.9	153
$200 & over	31	40.8	39.7	16	5.5	510
Total	10,868	40.1	12.3	291	100.0	27

[1] Expanded income equals adjusted gross income plus minimum tax preferences less investment interest expense to the extent of investment income.

[2] Less than $500,000 or 0.05 percent.

NOTE—Details may not add to totals because of rounding.

Table 4.—Distribution of the Administration's Proposed Change of the Medical and Casualty Itemized Deductions [1] as Compared to Present Law

[1978 income level]

Expanded income class [2] (thousands)	Returns with tax increase (thousands)	Returns with tax increase as a percent of— Returns itemizing	All returns	Amount of tax increase (millions)	Percentage distribution of tax increase	Average tax increase
Below $5	90	20.8	0.4	$3	0.1	$30
$5 to $10	1,598	71.7	8.3	94	4.1	59
$10 to $15	3,320	78.2	23.5	262	11.5	79
$15 to $20	3,973	73.7	34.2	372	16.3	94
$20 to $30	6,019	72.7	46.4	671	29.3	111
$30 to $50	3,603	73.6	61.7	556	24.3	154
$50 to $100	891	68.3	62.4	218	9.5	244
$110 to $200	172	60.4	57.5	79	3.5	458
$200 & over	44	57.9	56.4	32	1.4	736
Total	19,709	72.6	22.3	2,286	100.0	116

[1] Combine the medical expense and casualty loss deductions under a floor of 10 percent of adjusted gross income.

[2] Expanded income equals adjusted gross income plus minimum tax preferences less investment interest expense to the extent of investment income.

NOTE—Details may not add to totals because of rounding.

Table 5.—Distribution of the Administration's Repeal of Certain State and Local Taxes [1] and Changes in the Medical and Casualty Deductions as Compared to Present Law

[1978 income level]

Expanded income class [2] (thousands)	Returns with tax increase (thousands)	Returns with tax increase as a percent of— Returns itemizing	All returns	Amount of tax increase (millions)	Percentage distribution of tax increase	Average tax increase
Below $5	145	33.6	0.6	$6	0.1	$41
$5 to $10	1,859	83.4	9.7	160	2.7	86
$10 to $15	4,109	96.8	29.1	500	8.4	122
$15 to $20	5,315	98.6	45.8	801	13.5	151
$20 to $30	8,229	99.4	63.4	1,733	29.2	211
$30 to $50	4,881	99.7	83.6	1,675	28.2	343
$50 to $100	1,292	99.1	90.4	713	12.0	552
$100 to $200	283	99.3	94.6	237	4.0	837
$200 & over	75	98.7	96.2	106	1.8	1,410
Total	26,188	96.5	29.6	5,930	100.0	226

[1] Including State and local sales, personal property, and gasoline taxes.
[2] Expanded income equals adjusted gross income plus minimum tax preferences less investment interest to the extent of investment income.

NOTE.—Details may not add to totals because of rounding.